

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities
Exchange Act of 1934

For the quarterly period ended **September 29, 2006**

Commission File Number: 001-9249

GRACO INC.

(Exact name of registrant as specified in its charter)

Minnesota

(State of incorporation)

41-0285640

(I.R.S. Employer Identification Number)

88 - 11th Avenue N.E.
Minneapolis, Minnesota

(Address of principal executive offices)

55413

(Zip Code)

(612) 623-6000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer X Accelerated Filer Non-accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No X

67,243,000 of the Registrant's Common Stock, \$1.00 par value were outstanding as of October 19, 2006.

GRACO INC. AND SUBSIDIARIES

INDEX

Page Number

PART I FINANCIAL INFORMATION

Item 1.	Financial Statements	
	Consolidated Statements of Earnings	3
	Consolidated Balance Sheets	4
	Consolidated Statements of Cash Flows	5
	Notes to Consolidated Financial Statements	6-14
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	15-17
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	18

Item 4.	Controls and Procedures	18
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PART II OTHER INFORMATION

Item 1A.	Risk Factors	19
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	19
Item 4.	Submission of Matters to a Vote of Security Holders	20
Item 6.	Exhibits	20

SIGNATURES

EXHIBITS

PART I

Item 1. GRACO INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF EARNINGS (Unaudited) (In thousands except per share amounts)

	<u>Thirteen Weeks Ended</u>		<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>
-				
Net Sales	\$202,199	\$176,934	\$613,047	\$546,099
Cost of products sold	<u>95,588</u>	<u>82,212</u>	<u>286,263</u>	<u>263,219</u>
Gross Profit	106,611	94,722	326,784	282,880
Product development	7,487	7,031	22,237	19,890
Selling, marketing and distribution	29,081	27,581	87,547	82,260
General and administrative	<u>15,039</u>	<u>13,148</u>	<u>43,516</u>	<u>38,257</u>
Operating Earnings	55,004	46,962	173,484	142,473
Interest expense	342	343	656	1,190
Other expense, net	<u>170</u>	<u>121</u>	<u>179</u>	<u>508</u>
Earnings before Income Taxes	54,492	46,498	172,649	140,775
Income taxes	<u>17,100</u>	<u>15,600</u>	<u>58,500</u>	<u>47,200</u>
Net Earnings	<u>\$ 37,392</u>	<u>\$ 30,898</u>	<u>\$114,149</u>	<u>\$ 93,575</u>
Basic Net Earnings per Common Share	\$.55	\$.45	\$ 1.68	\$ 1.36
Diluted Net Earnings per Common Share	\$.54	\$.44	\$ 1.65	\$ 1.34
Cash Dividends Declared per Common Share	\$.15	\$.13	\$.44	\$.39

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS (Unaudited) (In thousands)

ASSETS	<u>Sep 29, 2006</u>	<u>Dec 30, 2005</u>
Current Assets		
Cash and cash equivalents	\$ 9,192	\$ 18,664
Accounts receivable, less allowances of \$6,200 and \$5,900	132,871	122,854
Inventories	75,060	56,547
Deferred income taxes	18,685	14,038
Other current assets	1,533	1,795

Total current assets	237,341	213,898
Property, Plant and Equipment		
Cost	278,842	255,463
Accumulated depreciation	(160,793)	(148,965)
Property, plant and equipment, net	118,049	106,498
Prepaid Pension	30,950	29,616
Goodwill	66,244	52,009
Other Intangible Assets, net	52,159	39,482
Other Assets	3,810	4,127
Total Assets	\$ 508,553	\$ 445,630

LIABILITIES AND SHAREHOLDERS' EQUITY

Current Liabilities		
Notes payable to banks	\$ 22,284	\$ 8,321
Trade accounts payable	28,717	24,712
Salaries, wages and commissions	22,808	23,430
Dividends payable	9,744	9,929
Other current liabilities	47,557	45,189
Total current liabilities	131,110	111,581
Retirement Benefits and Deferred Compensation	37,356	35,507
Deferred Income Taxes	14,837	10,858
Shareholders' Equity		
Common stock	67,236	68,387
Additional paid-in capital	128,581	110,842
Retained earnings	131,767	112,506
Other, net	(2,334)	(4,051)
Total shareholders' equity	325,250	287,684
Total Liabilities and Shareholders' Equity	\$ 508,553	\$ 445,630

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)
(In thousands)

	Thirty-nine Weeks Ended	
	Sep 29, 2006	Sep 30, 2005
Cash Flows from Operating Activities		
Net Earnings	\$ 114,149	\$ 93,575
Adjustments to reconcile net earnings to net cash provided by operating activities		
Depreciation and amortization	19,031	17,603
Deferred income taxes	(5,975)	(95)
Share-based compensation	6,508	--
Excess tax benefit related to share-based payment arrangements	(2,500)	--
Change in:		
Accounts receivable	(3,965)	(3,762)
Inventories	(14,487)	1,783
Trade accounts payable	2,383	(1,385)
Salaries, wages and commissions	(1,484)	(1,187)
Retirement benefits and deferred compensation	299	(788)
Other accrued liabilities	2,328	1,898
Other	702	2,560
Net cash provided by operating activities	116,989	110,202
Cash Flows from Investing Activities		
Property, plant and equipment additions	(22,117)	(12,027)
Proceeds from sale of property, plant and equipment	101	136
Capitalized software additions	(200)	(785)
Acquisitions of businesses, net of cash acquired	(31,067)	(102,797)
Net cash used in investing activities	(53,283)	(115,473)

Cash Flows from Financing Activities

Borrowings on notes payable and lines of credit	42,834	75,346
Payments on notes payable and lines of credit	(29,320)	(64,989)
Excess tax benefit related to share-based payment arrangements	2,500	--
Common stock issued	11,540	9,573
Common stock retired	(69,754)	(35,238)
Cash dividends paid	(29,679)	(26,894)
Net cash provided by (used in) financing activities	(71,879)	(42,202)
Effect of exchange rate changes on cash	(1,299)	1,197
Net increase (decrease) in cash and cash equivalents	(9,472)	(46,276)
Cash and cash equivalents		
Beginning of year	18,664	60,554
End of period	\$ 9,192	\$ 14,278

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

- The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of September 29, 2006, and the related statements of earnings for the thirteen and thirty-nine weeks ended September 29, 2006 and September 30, 2005, and cash flows for the thirty-nine weeks ended September 29, 2006 and September 30, 2005 have been prepared by the Company and have not been audited.

In the opinion of management, these consolidated statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of Graco Inc. and Subsidiaries as of September 29, 2006, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2005 Annual Report on Form 10-K.

The results of operations for interim periods are not necessarily indicative of results that will be realized for the full fiscal year.

- The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	<u>Thirteen Weeks Ended</u>		<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>
Net earnings available to common shareholders	\$37,392	\$30,898	\$114,149	\$93,575
Weighted average shares outstanding for basic earnings per share	67,576	68,612	68,042	68,881
Dilutive effect of stock options computed using the treasury stock method and the average market price	1,135	1,095	1,151	1,125
Weighted average shares outstanding for diluted earnings per share	68,711	69,707	69,193	70,006
Basic earnings per share	\$.55	\$.45	\$ 1.68	\$ 1.36
Diluted earnings per share	\$.54	\$.44	\$ 1.65	\$ 1.34

Stock options to purchase 1,030,000 and 370,000 shares are not included in the 2006 and 2005 calculations of diluted earnings per share, respectively, because they would have been anti-dilutive.

- Statement of Financial Accounting Standards (SFAS) No. 123(R), "Share-Based Payment," became effective for the Company at the beginning of 2006. This standard requires compensation costs related to share-based payment transactions to be recognized in the financial statements. The Company adopted the standard using the modified prospective transition method, whereby compensation cost related to unvested awards as of the effective date are recognized as calculated for pro forma disclosures under SFAS No. 123, and cost related to new awards are recognized in accordance with SFAS No. 123(R). The Company continues to use the Black-Scholes option-pricing model to value option grants. The Company recognized share-based compensation cost of \$1.9 million in the third quarter of 2006, which reduced net income by \$1.4 million, or \$0.02 per weighted common share. For the thirty-nine weeks ended September 29, 2006, share-based compensation cost was \$6.5 million, which reduced net income by \$4.7 million, or \$0.07 per weighted common share.

Had share-based compensation cost for the Employee Stock Purchase Plan and stock options granted under various stock incentive plans been recognized prior to 2006, the Company's net earnings and earnings per share for the thirteen and thirty-nine weeks ended September 30, 2005 would have been reduced as follows (in thousands, except per share amounts):

	Thirteen Weeks Ended Sep 30, 2005	Thirty-nine Weeks Ended Sep 30, 2005
Net earnings		
As reported	\$30,898	\$93,575
Stock-based compensation, net of related tax effects	1,279	3,583
Pro forma	<u>\$29,619</u>	<u>\$89,992</u>
Net earnings per common share		
Basic as reported	\$.45	\$ 1.36
Basic pro forma	.43	1.31
Diluted as reported	.44	1.34
Diluted pro forma	.42	1.29

The Company has various stock incentive plans under which it grants stock options and restricted share awards to officers and other employees. The option exercise price is the market price on the date of grant. Options become exercisable at such time, generally over three or four years, and in such installments as set by the Company, and expire ten years from the date of grant.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions and results:

	<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>
Expected life in years	6.3	6.3
Interest rate	4.6%	4.2%
Volatility	27.8%	18.7%
Dividend yield	1.4%	1.4%
Weighted average fair value per share of options granted	\$12.97	\$8.24

Expected life is estimated based on vesting terms and exercise and termination history. Interest rate is based on the U.S. Treasury rate on zero-coupon issues with a remaining term equal to the expected life of the option. For 2006, expected volatility is based on historical volatility over a period commensurate with the expected life of options. Prior to 2006, volatility was based on historical volatility over a three-year period.

A summary of option activity for the thirty-nine weeks ended September 29, 2006 is shown below (in thousands, except per share and year amounts):

	<u>Option Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term (years)</u>	<u>Aggregate Intrinsic Value</u>
Outstanding, December 30, 2005	3,615	\$ 20.85		
Granted	703	41.11		
Exercised	(299)	15.10		
Canceled	(27)	33.17		
Outstanding, September 29, 2006	<u>3,992</u>	24.76	6.5	\$58,506
Exercisable, September 29, 2006	<u>2,291</u>	\$ 16.89	5.0	\$50,836

The aggregate intrinsic value of options exercised in the first nine months of the year was \$8.2 million in 2006 and \$6.3 million in 2005. As of September 29, 2006, there was \$9.9 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 1.3 years.

Under the Company's Employee Stock Purchase Plan, the purchase price of the shares is the lesser of 85 percent of the fair market value on the first day or the last day of the plan year. The Company issued 204,478 shares under this Plan in 2006 and 245,303 shares in 2005. The fair value of the employees' purchase rights under the Employee Stock Purchase Plan was estimated on the date of grant. The benefit of the 15 percent discount from the lesser of the fair market value per common share on the first day and the last day of the plan year was added to the fair value of the employees' purchase rights determined using the Black-Scholes option-pricing model with the following assumptions and results:

	<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>
Expected life in years	1.0	1.0
Interest rate	4.6%	4.4%
Volatility	24.0%	18.9%
Dividend yield	1.4%	1.4%
Weighted average fair value per share	\$10.18	\$8.26

Individual nonemployee directors of the Company may elect to receive all or part of their annual retainer, and/or payment for attendance at

Board or Committee meetings, in the form of shares of the Company's common stock instead of cash. The Company issued 8,502 shares under this arrangement in the first nine months of 2006 and 9,084 shares under this arrangement in the comparable period of 2005. The expense related to this arrangement is not significant.

Shares authorized for issuance under the various stock option and purchase plans are shown below (in thousands):

	Total Shares <u>Authorized</u>	Available for Future Issuance as of <u>Sep 29, 2006</u>
Employee Stock Incentive Plan	3,375	1,300
Stock Incentive Plan (2006)	7,375	4,598
Employee Stock Purchase Plan	19,744	550
	<hr/>	<hr/>
Total	30,494	6,448
	<hr/>	<hr/>

Amounts available for future issuance exclude outstanding options. Options outstanding as of September 29, 2006, include options granted under two plans that were replaced by the Stock Incentive Plan in 2001. No shares are available for future grants under those two plans. Shares authorized under the Stock Incentive Plan (2006) include an increase of 4 million shares approved by shareholders at the annual meeting of shareholders in April 2006. At the same meeting, shareholders approved the 2006 Employee Stock Purchase Plan, which authorizes 2 million shares of common stock. The new plan will become effective in March 2007, at which time any shares remaining authorized and unissued by the old plan will be cancelled.

4. The components of net periodic benefit cost for retirement benefit plans were as follows (in thousands):

	<u>Thirteen Weeks Ended</u>		<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>
Pension Benefits				
Service cost	\$ 998	\$ 1,154	\$ 4,072	\$ 3,509
Interest cost	2,597	2,482	7,815	7,453
Expected return on assets	(3,923)	(3,762)	(12,273)	(11,662)
Amortization and other	524	250	815	475
	<hr/>	<hr/>	<hr/>	<hr/>
Net periodic benefit cost (credit)	\$ 196	\$ 124	\$ 429	\$ (225)
	<hr/>	<hr/>	<hr/>	<hr/>
Postretirement Medical				
Service cost	\$ 195	\$ 181	\$ 695	\$ 631
Interest cost	351	395	1,191	1,215
Amortization of net loss	151	164	416	394
	<hr/>	<hr/>	<hr/>	<hr/>
Net periodic benefit cost	\$ 697	\$ 740	\$ 2,302	\$ 2,240
	<hr/>	<hr/>	<hr/>	<hr/>

5. Total comprehensive income was as follows (in thousands):

	<u>Thirteen Weeks Ended</u>		<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>
Net Income	\$37,392	\$30,898	\$114,149	\$93,575
Foreign currency translation adjustments	30	(107)	1,770	(1,881)
Minimum pension liability adjustment, net of tax	3	1	(53)	32
	<hr/>	<hr/>	<hr/>	<hr/>
Comprehensive income	\$37,425	\$30,792	\$115,866	\$91,726
	<hr/>	<hr/>	<hr/>	<hr/>

6. The Company has three reportable segments; Industrial, Contractor and Lubrication. The Company does not identify assets by segment. Sales and operating earnings by segment for the thirteen and thirty-nine weeks ended September 29, 2006 and September 30, 2005 were as follows (in thousands):

	<u>Thirteen Weeks Ended</u>		<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>
Net Sales				
Industrial	\$101,149	\$ 88,052	\$305,864	\$269,696
Contractor	78,659	75,318	249,518	232,665
Lubrication	22,391	13,564	57,665	43,738
	<hr/>	<hr/>	<hr/>	<hr/>
Consolidated	\$202,199	\$176,934	\$613,047	\$546,099
	<hr/>	<hr/>	<hr/>	<hr/>
Operating Earnings				
Industrial	\$ 31,233	\$ 23,618	\$ 95,795	\$ 70,282
Contractor	21,199	19,370	71,762	60,215
Lubrication	4,747	3,278	13,968	11,524
Unallocated Corporate	(2,175)	696	(8,041)	457
	<hr/>	<hr/>	<hr/>	<hr/>

Consolidated	<u>\$ 55,004</u>	<u>\$ 46,962</u>	<u>\$173,484</u>	<u>\$142,473</u>
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7. Major components of inventories were as follows (in thousands):

	<u>Sep 29, 2006</u>	<u>Dec 30, 2005</u>
Finished products and components	\$ 49,221	\$ 40,444
Products and components in various stages of completion	23,680	21,788
Raw materials and purchased components	<u>30,655</u>	<u>22,690</u>
	103,556	84,922
Reduction to LIFO cost	<u>(28,496)</u>	<u>(28,375)</u>
Total	<u>\$ 75,060</u>	<u>\$ 56,547</u>

8. Information related to other intangible assets follows (dollars in thousands):

	<u>Estimated Life (Years)</u>	<u>Original Cost</u>	<u>Amorti- zation</u>	<u>Foreign Currency Translation</u>	<u>Book Value</u>
<u>September 29, 2006</u>					
Customer relationships and distribution network	4 - 8	\$ 27,702	\$ (6,481)	\$ (144)	\$ 21,077
Patents, proprietary technology and product documentation	5 - 15	20,643	(3,546)	(58)	17,039
Trademarks, trade names and other	3 - 10	<u>5,114</u>	<u>(1,289)</u>	<u>(42)</u>	<u>3,783</u>
		53,459	(11,316)	(244)	41,899
Not Subject to Amortization: Brand names		<u>10,260</u>	<u>--</u>	<u>--</u>	<u>10,260</u>
Total		<u>\$63,719</u>	<u>\$(11,316)</u>	<u>\$ (244)</u>	<u>\$ 52,159</u>
<u>December 30, 2005</u>					
Customer relationships and distribution network	4 - 8	\$ 22,965	\$ (4,419)	\$ (427)	\$ 18,119
Patents, proprietary technology and product documentation	3 - 15	12,266	(2,065)	(174)	10,027
Trademarks, trade names and other	3 - 10	<u>1,774</u>	<u>(837)</u>	<u>--</u>	<u>937</u>
		37,005	(7,321)	(601)	29,083
Not Subject to Amortization: Brand names		<u>10,550</u>	<u>--</u>	<u>(151)</u>	<u>10,399</u>
Total		<u>\$47,555</u>	<u>\$ (7,321)</u>	<u>\$ (752)</u>	<u>\$ 39,482</u>

In the third quarter of 2006, the useful life of certain brand names was determined to be no longer indefinite. The original cost of such brand names, totaling \$3.5 million, is being amortized over a three-year period beginning July 1, 2006. Amortization of intangibles was \$2.1 million in the third quarter of 2006 and \$4.7 million year-to-date. Estimated annual amortization expense is as follows: \$6.8 million in 2006, \$8.1 million in 2007, \$7.6 million in 2008, \$6.8 million in 2009, \$ 5.7 million in 2010 and \$11.6 million thereafter.

9. Components of other current liabilities were (in thousands):

	<u>Sep 29, 2006</u>	<u>Dec 30, 2005</u>
Accrued insurance liabilities	\$ 8,788	\$ 7,848
Accrued warranty and service liabilities	6,601	7,649
Accrued trade promotions	6,846	6,584
Payable for employee stock purchases	4,347	5,710
Income taxes payable	5,425	4,075
Other	<u>15,550</u>	<u>13,323</u>
	<u>\$47,557</u>	<u>\$45,189</u>

A liability is established for estimated future warranty and service claims that relate to current and prior period sales. The Company estimates warranty costs based on historical claim experience and other factors including evaluating specific warranty issues. Following is a summary of activity in accrued warranty and service liabilities (in thousands):

Thirty-nine Weeks Ended <u>Sep 29, 2006</u>	Year Ended <u>Dec 30, 2005</u>
---	-----------------------------------

Balance, beginning of year	\$ 7,649	\$ 9,409
Charged to expense	2,978	6,045
Margin on parts sales reversed	1,343	1,201
Reductions for claims settled	(5,369)	(9,006)
	<hr/>	<hr/>
Balance, end of period	\$ 6,601	\$ 7,649
	<hr/>	<hr/>

10. In April 2006, the Company announced that it would close its plant and office facilities in Lakewood, New Jersey. The Company intends to move the Lakewood operation to North Canton, Ohio, where it currently has a manufacturing facility. As part of this consolidation, the Company is building a 60,000 square foot expansion of the North Canton facility. The Company is also moving its spray foam production from Vilanova, Spain to Minneapolis, Minnesota. The Company has incurred approximately \$2 million of the estimated \$4 to \$5 million of costs and expenses for actions related to these plans, including approximately \$1 million in the third quarter.
11. In July 2006, the Company purchased the stock of Lubriquip, Inc. for approximately \$31 million cash. Lubriquip, with sales of approximately \$30 million in 2005, is a manufacturer of centralized and automated oil and grease lubrication systems, force-feed lubricators, metering devices and related electronic controls and accessories. The products, brands, distribution channels and engineering capabilities of Lubriquip will expand and complement the Company's Lubrication Equipment business.

Lubriquip has manufacturing facilities in Warrensville Heights, Ohio and Madison, Wisconsin. The Company plans to close both facilities in 2007 and combine those operations with the Company's existing lubrication businesses in a new facility in Minnesota.

The purchase price has not been finalized and is subject to final determination of acquired asset and liability balances. The preliminary purchase price was allocated based on estimated fair values as follows (in thousands):

Accounts receivable and prepaid expenses	\$ 2,400
Inventories	3,700
Property, plant and equipment	3,000
Prepaid pension	400
Identifiable intangible assets	17,000
Goodwill	13,500
	<hr/>
Total purchase price	40,000
Liabilities assumed	(8,900)
	<hr/>
Net assets acquired	\$31,100
	<hr/>

Identifiable intangible assets and weighted average estimated useful life are as follows (dollars in thousands):

Product documentation (8 years)	\$ 8,500
Customer relationships (7 years)	3,700
Proprietary technology (5 years)	1,600
	<hr/>
Total (7 years)	13,800
Brand names (indefinite useful life)	3,200
	<hr/>
Total identifiable intangible assets	\$17,000
	<hr/>

None of the goodwill or identifiable intangible assets is expected to be deductible for tax purposes.

12. In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109." FIN 48 is effective for the Company beginning in 2007 and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company has not yet determined the impact, if any, the adoption of FIN 48 will have on its financial condition or results of operations.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." SFAS No. 158 requires the recognition of the funded status of a defined benefit plan in the statement of financial position, requires that changes in the funded status be recognized through comprehensive income and expands disclosures. SFAS No. 158 is effective for the Company for year-end 2006 financial statements. The Company is in the process of evaluating the impact of SFAS No. 158 on its consolidated financial statements. The Company estimates that if the provisions of SFAS No. 158 had been effective for year-end 2005, they would have decreased shareholders' equity by approximately \$32 million.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement establishes a consistent framework for measuring fair value and expands disclosures on fair value measurements. SFAS No. 157 is effective for the Company starting in fiscal 2008. The Company has not determined the impact, if any, the adoption of this statement will have on its consolidated financial statements.

Item 2. GRACO INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

For both the quarter and year-to-date, sales increased at a higher rate than total cost of products sold and operating expenses, resulting in increases in net earnings. As a percentage of sales, net earnings for the third quarter improved to 18.5 percent compared to 17.5 percent last year. Year-to-date net earnings as a percentage of sales improved to 18.6 percent compared to 17.1 percent last year.

Lubriquip, acquired in July 2006, contributed \$6 million of sales and no net earnings after incurring non-cash charges of \$1.2 million. Expenses in 2006 include share-based compensation and contributions to the Company's charitable foundation. There were no comparable expenses included in the first nine months of 2005. Those two items plus Lubriquip expenses account for more than two-thirds of the \$13 million increase in year-to-date operating expenses. Currency translation did not have a significant impact on 2006 sales and net earnings.

Net Sales

Sales by segment and geographic area were as follows (in thousands):

	<u>Thirteen Weeks Ended</u>		<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>	<u>Sep 29, 2006</u>	<u>Sep 30, 2005</u>
By Segment				
Industrial	\$101,149	\$ 88,052	\$305,864	\$269,696
Contractor	78,659	75,318	249,518	232,665
Lubrication	22,391	13,564	57,665	43,738
	<hr/>	<hr/>	<hr/>	<hr/>
Consolidated	\$202,199	\$176,934	\$613,047	\$546,099
	<hr/>	<hr/>	<hr/>	<hr/>
By Geographic Area				
Americas ¹	\$133,339	\$117,598	\$409,923	\$364,188
Europe ²	43,334	36,390	128,234	112,416
Asia Pacific	25,526	22,946	74,890	69,495
	<hr/>	<hr/>	<hr/>	<hr/>
Consolidated	\$202,199	\$176,934	\$613,047	\$546,099
	<hr/>	<hr/>	<hr/>	<hr/>

¹ North and South America, including the U.S.

² Europe, Africa and Middle East

Sales for the quarter and year-to-date increased compared to last year in all reportable segments and regions. Sales for the quarter showed double-digit percentage growth in all regions.

Industrial segment sales increased 15 percent for the quarter and 13 percent year-to-date, with strong increases in the Americas and Europe. In the Americas, there were gains in all major product categories. Europe had increases in most major product categories and regions.

Contractor segment sales increased 4 percent for the quarter and 7 percent year-to-date. Growth for the quarter came from Europe (up 25 percent) and Asia Pacific (up 20 percent). There is strong demand for airless spray products in those regions. In the Americas, sales are flat for the quarter and up 4 percent year-to-date.

Lubrication segment sales increased 65 percent for the quarter and 32 percent year-to-date. Lubriquip contributed 44 percentage points of growth to the quarter and 14 percentage points of growth year-to-date. All major lubrication products, including the electric fuel and oil pump products acquired late in 2005, contributed to the growth.

Gross Profit

Gross profit as a percentage of sales was 52.7 percent for the third quarter and 53.3 percent year-to-date, compared to 53.5 percent and 51.8 percent, respectively, last year. The decrease in the margin rate for the quarter was due to the impact of the Lubriquip acquisition, provisions for excess and discontinued inventory, and costs related to closing Gusmer facilities. More than half of the increase in the year-to-date margin rate was due to the recognition of higher costs assigned to inventories of acquired operations in 2005. Favorable factory productivity and volume in 2006 contributed to the improvement in year-to-date gross margin percentage.

Operating Expenses

Compared to last year, operating expenses increased by \$3.8 million for the quarter and \$12.9 million year-to-date. Lubriquip operating expenses totaled \$1.8 million for the quarter and year-to-date. Share-based compensation included in 2006 operating expenses was \$1.5 million for the quarter and \$5.3 million year-to-date. Charitable foundation contributions were \$0.3 million for the quarter and \$1.6 million year-to-date. Expenses as a percentage of sales were 25.5 percent for the quarter and 25.0 percent year-to-date, compared to 27.0 percent and 25.7 percent, respectively, last year.

Income Taxes

The effective tax rate was 31.4 percent for the third quarter and 33.9 percent year-to-date, compared to 33.5 percent for both quarter and year-to-date last year. The lower effective tax rate in the third quarter resulted from the effects of expiring statutes of limitation, the resolution of prior years' income tax audits, and the higher than expected benefits from the extra-territorial income exclusion and domestic production activity deduction. The larger benefit of the domestic production activity deduction is expected to reduce future effective tax rates by approximately 50 basis points.

Liquidity and Capital Resources

Significant uses of cash in the first nine months of 2006 included \$70 million for purchases and retirement of Company common stock, \$31 million for the acquisition of Lubriquip, \$30 million for payment of dividends and \$6 million for the acquisition of a new facility in Anoka, Minnesota for the Lubrication segment.

During the first nine months of 2005, significant uses of cash included \$103 million for acquisitions of businesses, \$27 million of dividends paid and \$35 million for purchases and retirement of Company common stock. The Company used cash on hand and a \$40 million advance from a line of credit to fund the 2005 acquisitions.

The Company had unused lines of credit available at September 29, 2006 totaling \$128 million, including a one-year, \$30 million uncommitted line established in July 2006. Cash balances of \$9 million at September 29, 2006, internally generated funds and unused financing sources provide the Company with the financial flexibility to meet liquidity needs, including the following:

- Improvement of the new manufacturing / warehouse / office facility for the Lubrication segment, estimated at approximately \$8 million.
- Costs related to the planned move of Lubriquip operations to Minnesota and consolidation of all Lubrication operations into the new facility. A preliminary estimate of such costs is \$2 million.
- Remaining costs related to the move and consolidation of the operations currently located in Lakewood, New Jersey and Vilanova, Spain, expected not to exceed \$2 million.

Outlook

Results for the first nine months were in line with management's expectations. While the short cycle nature of the business provides a limited view of future product demand, management remains confident that sales and earnings will be higher in 2006.

SAFE HARBOR CAUTIONARY STATEMENT

A forward-looking statement is any statement made in this report and other reports that the Company files periodically with the Securities and Exchange Commission, or in press or earnings releases, analyst briefings and conference calls, which reflects the Company's current thinking on market trends and the Company's future financial performance at the time they are made. All forecasts and projections are forward-looking statements. The Company undertakes no obligation to update these statements in light of new information or future events.

The Company desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 by making cautionary statements concerning any forward-looking statements made by or on behalf of the Company. The Company cannot give any assurance that the results forecasted in any forward-looking statement will actually be achieved. Future results could differ materially from those expressed, due to the impact of changes in various factors. These risk factors include, but are not limited to: economic conditions in the United States and other major world economies, currency fluctuations, political instability, changes in laws and regulations, and changes in product demand. Please refer to Item 1A of, and Exhibit 99 to, the Company's Annual Report on Form 10-K for fiscal year 2005 (and most recent Form 10-Q, if applicable) for a more comprehensive discussion of these and other risk factors. These reports are available on the Company's website at www.graco.com and the Securities and Exchange Commission's website at www.sec.gov.

Investors should realize that factors other than those identified above and in Exhibit 99 might prove important to the Company's future results. It is not possible for management to identify each and every factor that may have an impact on the Company's operations in the future as new factors can develop from time to time.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There are no material changes related to market risk from the disclosures made in the Company's 2005 Annual Report on Form 10-K.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

As of the end of the fiscal quarter covered by this report, the Company carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures. This evaluation was done under the supervision and with the participation of the Company's Chairman, President and Chief Executive Officer, Chief Financial Officer and Treasurer, and Vice President, General Counsel and Secretary. Based upon that evaluation, they concluded that the Company's disclosure controls and procedures are effective in gathering, analyzing and disclosing information needed to satisfy the Company's disclosure obligations under the Exchange Act.

Changes in internal controls

During the quarter, there was no change in the Company's internal control over financial reporting that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes to the Company's risk factors from those disclosed in the Company's 2005 Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities

On February 20, 2004, the Board of Directors authorized the Company to purchase up to a total of 3,000,000 shares of its outstanding common stock, primarily through open-market transactions. This authorization effectively expired February 17, 2006, upon Board approval authorizing the purchase of up to 7,000,000 shares, expiring on February 29, 2008.

In addition to shares purchased under the Board authorization, the Company purchases shares of common stock held by employees who wish to tender owned shares to satisfy the exercise price or tax withholding on option exercises.

Information on issuer purchases of equity securities follows:

<u>Period</u>	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (at end of period)
Jul 1, 2006 - Jul 28, 2006	45,000	\$38.32	45,000	6,077,900
Jul 29, 2006 - Aug 25, 2006	336,600	\$38.76	336,600	5,741,300
Aug 26, 2006 - Sep 29, 2006	240,000	\$38.10	240,000	5,501,300

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 6. Exhibits

4.1	Credit Agreement dated July 10, 2006, between the Company and U.S. Bank, N.A.
10.1	Restoration Plan (2005 Statement)
31.1	Certification of Chairman, President and Chief Executive Officer pursuant to Rule 13a-14(a)
31.2	Certification of Chief Financial Officer and Treasurer pursuant to Rule 13a-14(a)
32	Certification of Chairman, President and Chief Executive Officer, and Chief Financial Officer and Treasurer pursuant to Section 1350 of Title 18, U.S.C.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

GRACO INC.

Date: October 25, 2006

By: /s/ David A. Roberts

David A. Roberts
Chairman, President and Chief Executive Officer
(Principal Executive Officer)

Date: October 25, 2006

By: /s/ James A. Graner

James A. Graner
Chief Financial Officer and Treasurer
(Principal Financial Officer)

PROMISSORY NOTE

\$25,000,000

July 10, 2006

Graco Inc.
88 11th Avenue Northwest
Minneapolis, Minnesota 55413
(Individually and collectively "Borrower")

U.S. Bank National Association
800 Nicollet Mall
Mail Code BC-MN-H03P
Minneapolis, Minnesota 55402
Attention: Michael J. Reymann
(Hereinafter referred to as "Bank")

Borrower promises to pay to the order of Bank, in lawful money of the United States of America, at its office indicated above or wherever else Bank may specify, the sum of \$25,000,000 (as the same may be reduced from time to time pursuant to that Section hereof titled "Reduction or Termination of Commitment", the "Committed Amount") or such sum as may be advanced and outstanding from time to time, with interest on the unpaid principal balance at the rate and on the terms provided in this Promissory Note (including all renewals, extensions or modifications hereof, this "Note").

LINE OF CREDIT ADVANCES. Borrower may borrow, repay and reborrow, and, upon the request of Borrower, Bank shall advance and readvance under this Note from time to time until the maturity hereof (each, including any portion thereof, an "Advance" and together the "Advances"), so long as the principal balance outstanding under this Note after such Advance plus the aggregate amount of undrawn Letters of Credit plus the aggregate amount of unreimbursed drawings under all Letters of Credit does not exceed the Committed Amount. Bank shall have no obligation to make Advances under this Note or issue Letters of Credit if a Default has occurred and is continuing. As of the date of each proposed Advance, Borrower shall be deemed to represent that each representation made in the Loan Documents is true in all material respects as of such date.

USE OF PROCEEDS. Borrower shall use the proceeds of the loan(s) evidenced by this Note for the commercial purposes of Borrower, as follows: refinance of existing debt and general business purposes (including without limitation acquisition financing).

LETTERS OF CREDIT. Upon the request of Borrower for a standby Letter of Credit under this Note, subject to the reasonable satisfaction by the Bank with the proposed form and beneficiary and absent any regulatory prohibition, Bank shall issue such Letter of Credit, provided that, after such issuance, the principal balance outstanding under this Note plus the aggregate amount of undrawn Letters of Credit plus the aggregate amount of unreimbursed drawings under all Letters of Credit shall not exceed the Committed Amount. Subject to the terms of this Note, Borrower may borrow hereunder to pay reimbursement obligations due Bank under Letters of Credit. With respect to each issuance of a Letter of Credit, Borrower shall execute Bank's form "Continuing Reimbursement Agreement for Letters of Credit" and the Bank's form of "Application for Letter of Credit" for each Letter of Credit. Upon termination of Bank's obligation to Advance under this Note, whether by maturity, Default or otherwise, Borrower shall deliver immediately to Bank cash collateral in an amount equal to the aggregate amount of outstanding undrawn Letters of Credit or provide Bank with other credit support for such undrawn Letters of Credit reasonably acceptable to Bank. **Letter of Credit Fees.** Borrower shall pay a Standby LC Fee with respect to each Letter of Credit from the date of issuance through the date of expiration, draw or other termination, at the Standby LC Fee rate on the amount of each Letter of Credit. Borrower shall pay to Bank Bank's standard processing fees in connection with amendment, issuance, negotiation, drawing, renewal or extension of each Letter of Credit. No Letter of Credit shall be deemed to be issued under this Note unless Borrower has specifically requested that it be issued hereunder, and all references in this Note to Letters of Credit shall be deemed to refer only to Letters of Credit issued under this Note.

UNUSED COMMITMENT FEE. Borrower shall pay an Unused Commitment Fee from the date hereof through the Maturity Date at the Unused Commitment Fee rate on the unused Committed Amount (with loans and the face amount of outstanding Letters of Credit being deemed usage of the Committed Amount).

INTEREST RATES AND FEES. The variable pricing grid below is referred to herein as the "Pricing Grid". The "LIBOR Spread", "Unused Commitment Fee", and the "Standby LC Fee" shall be determined at any time by reference to the Leveraged Ratio calculated as of the end of the most recent fiscal quarter preceding the day such spread or fee is determined for which financial statements have been delivered under that Section of this Note titled "Financial Information" and the Pricing Grid. Until delivery of such financial statements for the fiscal quarter ending June 30, 2006, the "LIBOR Spread", the "Unused Commitment Fee" and the "Standby LC Fee" shall be determined by reference to an assumed Leverage Ratio of <1.00x and the Pricing Grid. All interest and fees are stated as annual rates in the Pricing Grid.

Leverage Ratio	LIBOR Spread	Unused Commitment Fee	Standby LC Fee
<1.00x	0.33%	0.07%	0.33%
≥1.00 to 2.00x	0.45%	0.10%	0.45%
≥2.0x to 3.0x	0.55%	0.12%	0.55%
≥3.0x	0.75%	0.14%	0.75%

INTEREST RATE DEFINITIONS.

LIBOR Rate Loan and Prime Rate Loan are defined below.

Loan Period. “Loan Period” means the period commencing on the advance, conversion or continuation date, as the case may be, of the applicable LIBOR Rate Loan and ending on the numerically corresponding day 1, 2, 3 or 6 months thereafter matching the interest rate term selected by Borrower; provided, however, (a) if any Loan Period would otherwise end on a day which is not a New York Banking Day, then the Loan Period shall end on the next succeeding New York Banking Day unless the next succeeding New York Banking Day falls in another calendar month, in which case the Loan Period shall end on the immediately preceding New York Banking Day; or (b) if any Loan Period begins on the last New York Banking Day of a calendar month (or on a day for which there is no numerically corresponding day in the calendar month at the end of the Loan Period), then the Loan Period shall end on the last New York Banking Day of the calendar month at the end of such Loan Period.

Money Markets. “Money Markets” refers to one or more wholesale funding markets available to and selected by Bank, including negotiable certificates of deposit, commercial paper, eurodollar deposits, bank notes, federal funds, interest rate swaps or others.

New York Banking Day. “New York Banking Day” means any day (other than a Saturday or Sunday) on which commercial banks are open for business in New York, New York.

INTEREST RATE SELECTION AND ADJUSTMENT. Interest Rate Options. Interest shall accrue on the unpaid principal balance of each Advance from the date of such Advance at one of the following per annum rates selected by Borrower: (i) upon notice to Bank, the prime rate announced by Bank from time to time, as and when such rate changes (a “Prime Rate Loan”); or (ii) upon a minimum of two New York Banking Days prior notice, the LIBOR Spread plus the 1, 2, 3 or 6 month LIBOR rate quoted by Bank from Telerate Page 3750 or any successor thereto (which shall be the LIBOR rate in effect two New York Banking Days prior to commencement of the advance), adjusted for any reserve requirement and any subsequent costs arising from a change in government regulation (a “LIBOR Rate Loan”). Interest for each Loan Period shall accrue each day during such Loan Period, commencing on and including the first day to but excluding the last day.

In the event Borrower does not timely select another interest rate option at least two New York Banking Days before the end of the Loan Period for a LIBOR Rate Loan, Bank may at any time after the end of the Loan Period convert the LIBOR Rate Loan to a Prime Rate Loan, but until such conversion, the funds advanced under the LIBOR Rate Loan shall continue to accrue interest at the same rate as the interest rate in effect for such LIBOR Rate Loan prior to the end of the Loan Period.

No LIBOR Rate Loan may extend beyond the maturity of this Note. In any event, if the Loan Period for a LIBOR Rate Loan should happen to extend beyond the maturity of this Note, such loan must be prepaid at the time this Note matures. Bank's internal records of applicable interest rates shall be determinative in the absence of manifest error. Each LIBOR Rate Loan shall be in a minimum principal amount of \$50,000.

There shall be no more than 10 LIBOR Rate Loans having different Loan Periods outstanding at any time.

Funding Loss Protection. If a LIBOR Rate Loan is prepaid prior to the end of the Loan Period, as defined above, for such loan, whether voluntarily or because prepayment is required due to this Note maturing or due to acceleration of this Note upon default or otherwise, Borrower agrees to pay all of Bank's reasonable costs and expenses, and Interest Differential (as determined by Bank) incurred as a result of such prepayment. The term “Interest Differential” shall mean that sum equal to the greater of zero or the financial loss incurred by Bank resulting from prepayment, calculated as the difference between (i) the amount of interest Bank would have earned over the remainder of the LIBOR Period had Bank been able to invest the funds from the prepayment in Money markets at the rates available as of the first day of the LIBOR Rate Loan, and (ii) the amount of interest Bank will actually earn over the remainder of the LIBOR Period from investment of the funds from the prepayment in Money Markets at the rates available as of the date of prepayment. Because of the short-term nature of this facility, Borrower agrees that the Interest Differential shall not be discounted to its present value. Any prepayment of a LIBOR Rate Loan shall be in an amount equal to the remaining entire principal balance of such LIBOR Rate Loan.

Default Rate. In addition to all other rights contained in this Note, if a Default occurs, and as long as a Default continues, (a) Borrower shall no longer have the option to request a LIBOR Rate Loan and (b) the outstanding principal amount of this Note and all other overdue Obligations shall bear interest at a rate per annum equal to the Prime Rate plus 2% (“Default Rate”); provided, however, that during the balance of any Loan Period applicable to an LIBOR Rate Loan, the Default Rate with respect to such Advance shall be a rate per annum equal to the LIBOR Rate Loan applicable to such Advance plus 2%. The Default Rate shall also apply from acceleration until the Obligations or any judgment thereon is paid in full.

Notice and Manner of Borrowing and Rate Conversion. Borrower shall give Bank irrevocable telephonic notice of each proposed Advance not later than noon local time at the office of Bank first shown above on the same day as the date of such proposed Advance, in the case of a Prime Rate Loan, or at least two New York Banking Days prior to the date of such proposed Advance, in the case of a LIBOR Rate Loan. Each such notice shall specify (i) the date of such Advance, which shall be a New York Banking Day, and that such Advance is to be made under this Note, (ii) the amount of such Advance, (iii) whether such Advance is to be initially funded as a Prime Rate Loan or a LIBOR Rate Loan, and (iv) in the case of a LIBOR Rate Loan, the duration of the Loan Period applicable thereto. Notices received after noon local time at the office of Bank first shown above shall be deemed received on the next New York Banking Day. No Advance shall be deemed to be made under this Note unless Borrower has specifically requested that it be made hereunder, and all references in this Note to Advances shall be deemed to refer only to Advances made under this Note.

Subject to the above limitations, Borrower shall have the option from time to time to convert all or any part of an Advance into a Prime Rate Loan or a LIBOR Rate Loan, or to continue all or any part of a LIBOR Rate Loan as such with the same or a different Loan Period; provided, however, that a LIBOR Rate Loan may be converted or continued only on the last day of the Loan Period applicable thereto. Borrower shall give Bank irrevocable telephonic notice of any continuation or conversion of an Advance not later than noon local time at the office of Bank first shown above on the date of the requested conversion, in the case of conversion of a LIBOR Rate Loan to a Prime Rate Loan, or at least two New York Banking Days prior to the date of the requested continuation or conversion, in the case of a conversion of a Prime Rate Loan into a LIBOR Rate Loan or a continuation of a LIBOR Rate Loan as such. Each such notice shall specify (i) the date of such continuation or conversion, (ii) the amount to be continued or converted, and (iii) in the case of continuations as or conversions to LIBOR Rate Loans, the Loan Period applicable thereto.

Interest and Fee Computation. Interest and fees, if any, shall be computed on the basis of the actual days elapsed and a year of 360 days.

REPAYMENT TERMS. Accrued interest, accrued Standby LC Fees and accrued Unused Commitment Fees shall be due and payable in consecutive monthly payments commencing on July 31, 2006, and continuing on the last day of each month thereafter. In any event, all principal and accrued interest shall be due and payable on July 31, 2007 (the “Maturity Date”).

If Borrower subscribes to Bank's cash management services and such services are applicable to this line of credit, the terms of such service shall control the manner in which funds are transferred between the applicable demand deposit account and the line of credit for credit or debit to the

line of credit.

Borrower authorizes Bank to debit the account of Borrower maintained with Bank that is designated by Borrower from time to time for payments of interest, Standby LC Fees and Unused Commitment Fees, provided that if funds available from such account are not sufficient to make such payments, Borrower remains obligated to make such payments from other sources.

APPLICATION OF PAYMENTS. Monies received by Bank from any source for application toward payment of the Obligations shall be applied to accrued interest and fees, to the extent such interest and fees are then due and owing, and then to principal. If a Default occurs, and so long as such Default is continuing, monies may be applied to the Obligations in any manner or order deemed appropriate by Bank.

If any payment received by Bank under this Note or other Loan Documents is rescinded, avoided or for any reason returned by Bank because of any adverse claim or threatened action, the returned payment shall remain payable as an obligation of all persons liable under this Note or other Loan Documents as though such payment had not been made.

REDUCTION OR TERMINATION OF COMMITMENT. Borrower may at any time and from time to time, upon not less than three New York Banking Days' prior written notice to Bank, permanently reduce in part the Commitment Amount or terminate entirely the commitment of the Bank to make Advances under this Note, in each case without premium or penalty, provided that any such partial reduction of the Commitment Amount shall be in integral multiples of \$500,000 and no such partial reduction shall reduce the Commitment Amount to an amount which is less than the sum at the time of the principal balance outstanding under this Note plus the aggregate amount of undrawn Letters of Credit plus the aggregate amount of unreimbursed drawings under all Letters of Credit. Upon any termination by Borrower in its entirety of the commitment of the Bank to make Advances under this Note, Borrower shall pay all of the Obligations in full.

DEFINITIONS. **Affiliate.** Affiliate shall have the meaning as defined in 11 U.S.C. § 101, except that the term "Borrower" shall be substituted for the term "Debtor" therein. **Agreement Accounting Principles.** Agreement Accounting Principles means generally accepted accounting principles as in effect in the United States from time to time. **Loan Documents.** The term "Loan Documents", as used in this Note and the other Loan Documents, refers to all documents executed in connection with or related to the loan evidenced by this Note and any prior notes which evidence all or any portion of the loan evidenced by this Note, and any letters of credit issued pursuant to any loan agreement to which this Note is subject, any applications for such letters of credit and any other documents executed in connection therewith or related thereto and any renewals or modifications thereof, whenever any of the foregoing are executed, but does not include swap agreements (as defined in 11 U.S.C. § 101). **Material Adverse Effect.** The term Material Adverse Effect shall mean, with respect to any event, act, condition or occurrence of whatever nature (including any adverse determination in any litigation, arbitration, or governmental investigation or proceeding), whether singly or in conjunction with any other event or events, act or acts, condition or conditions, or occurrence or occurrences whether or not related, a material adverse change in, or a material adverse effect on, (a) the business, results of operations, financial condition, assets or liabilities of Borrower and its Subsidiaries taken as a whole, (b) the ability of Borrower to perform any of its obligations under the Loan Documents, (c) the rights and remedies of the Bank under any of the Loan Documents or (d) the legality, validity or enforceability of any of the Loan Documents. **Obligations.** The term "Obligations", as used in this Note and the other Loan Documents, refers to any and all indebtedness, promises, covenants, agreements and other obligations under this Note and under any other Loan Document. Any reference in this Note or in any other Loan Document to payment, or final payment, in full of the Obligations shall mean the payment in full in cash of all Obligations other than contingent indemnification Obligations (or, in the case of undrawn Letters of Credit, the cash collateralization thereof or provision of other credit support therefor in accordance with the terms of the Section hereof titled "Letters of Credit"). **Subsidiary.** Subsidiary shall mean any business in which Borrower holds, directly or indirectly, a controlling interest. **Certain Other Terms.** All terms that are used but not otherwise defined in any of the Loan Documents shall have the definitions provided in the Uniform Commercial Code.

ATTORNEYS' FEES AND OTHER COLLECTION COSTS. Borrower shall pay all of Bank's reasonable expenses incurred to enforce or collect any of the Obligations including, without limitation, reasonable arbitration, paralegals', attorneys' and experts' fees and expenses, whether incurred without the commencement of a suit, in any trial, arbitration, or administrative proceeding, or in any appellate or bankruptcy proceeding.

USURY. If at any time the effective interest rate under this Note would, but for this paragraph, exceed the maximum lawful rate, the effective interest rate under this Note shall be the maximum lawful rate, and any amount received by Bank in excess of such rate shall be applied to principal and then to fees and expenses, or, if no such amounts are owing, returned to Borrower.

GRACE/CURE PERIOD. **Grace Period.** The failure of timely payment of the interest or fees shall not be a Default until 5 days after such payment is due.

DEFAULT. If any of the following occurs and is not cured within the applicable Cure Period, a default ("Default") under this Note shall exist: **Nonpayment; Nonperformance.** The failure of timely payment (subject to the 5 day grace period above) or performance of the Obligations or Default, however denominated, under this Note or any other Loan Documents (and such failure of performance or Default, if not a failure to pay, shall continue for 30 or more days after the earlier to occur of Borrower's receipt of notice thereof from Bank or the date an officer of Borrower otherwise has knowledge, or should reasonably have had knowledge, of the occurrence thereof). **False Warranty.** A warranty or representation made or deemed made in the Loan Documents or furnished to Bank by Borrower in connection with the loan evidenced by this Note proves materially false, or if of a continuing nature, becomes materially false. **Cross Default.** At Bank's option, any default in payment or performance of any obligation under any other loans, contracts or agreements of Borrower or any Subsidiary of Borrower with Bank or its affiliates. **Bankruptcy.** Appointment of a receiver for, assignment for the benefit of creditors of, or commencement of any bankruptcy or insolvency proceeding by or against, Borrower or any of its Subsidiaries (which proceeding, if not instituted, consented to or acquiesced in by Borrower or such Subsidiary, remains undismissed or unstayed and in effect for a period of 60 consecutive days).

REMEDIES UPON DEFAULT. If a Default occurs under this Note or any Loan Documents, Bank may at any time thereafter so long as such Default is continuing, take the following actions: **Acceleration Upon Default/Termination.** Accelerate the maturity of this Note and, at Bank's option, any or all other Obligations, whereupon this Note and the accelerated Obligations shall be immediately due and payable, and terminate Bank's obligation to make Advances under this Note or issue Letters of Credit; provided, however, if the Default is based upon a bankruptcy or insolvency proceeding commenced by or against Borrower, all Obligations shall automatically and immediately be due and payable, all LIBOR - Based Rate Advances shall convert to Prime Rate Loans and Bank's obligation to make Advances under this Note or issue Letters of Credit shall terminate. **Cumulative.** Exercise any rights and remedies as provided under the Note and other Loan Documents, or as provided by law or equity.

REPRESENTATIONS. **Power and Authorization.** Borrower has the power and authority to execute, deliver and perform, and by all necessary action has authorized the execution, delivery and performance of, all of its obligations under this Note and any other Loan Document to which it is a party. **Organization and Authority.** Borrower and each Subsidiary of Borrower is duly created, validly existing and in good standing under the laws of the state of its organization, and has all powers, governmental licenses, authorizations, consents and approvals required to operate its business as now conducted except where the failure to have any such power, governmental license, authorization, consent or approval could not be reasonably expected to have a Material Adverse Effect. Borrower and each Subsidiary of Borrower is duly qualified, registered and in good standing in each jurisdiction where qualification or registration is required by the nature of its business or the character and location of its property,

business or customers, and in which the failure to so qualify or be so registered or in good standing, as the case may be, in the aggregate, could be reasonably expected to have a Material Adverse Effect. **No Litigation.** Except as disclosed to Bank in writing prior to the execution and delivery of this Note, there are no pending or, to the knowledge of Borrower, threatened suits, regulatory or administrative proceedings, arbitrations or penalties against Borrower or any Subsidiary of Borrower that could be reasonably expected to have a Material Adverse Effect. **ERISA.** Each employee pension benefit plan, as defined in ERISA, maintained by Borrower meets, as of the date hereof, the minimum funding standards of ERISA and all applicable regulations thereto and requirements thereof, and of the Internal Revenue Code of 1986, as amended. No "Prohibited Transaction" or "Reportable Event" (as both terms are defined by ERISA) has occurred with respect to any such plan. **Regulation U.** None of the proceeds of the credit shall be used directly or indirectly for the purpose of purchasing or carrying any margin stock in violation of any of the provisions of Regulation U of the Board of Governors of the Federal Reserve System ("Regulation U"), or for the purpose of reducing or retiring any indebtedness which was originally incurred to purchase or carry margin stock or for any other purchase which might render the loan evidenced by this Note a "Purpose Credit" within the meaning of Regulation U.

FINANCIAL INFORMATION. Borrower agrees that from the date hereof until payment in full of the Obligations: **Annual.** Borrower shall deliver to Bank, within 120 days after the close of each fiscal year, audited financial statements reflecting its operations during such fiscal year, including, without limitation, a balance sheet, profit and loss statement, statement of cash flows and officer's compliance certificate with supporting schedules; all on a consolidated basis with respect to Borrower and its Subsidiaries, and in reasonable detail, prepared in conformity with generally accepted accounting principles, applied (except as otherwise disclosed in such financial statements) on a basis consistent with that of the preceding year. All such statements shall be examined by Deloitte & Touche LLP or another independent certified public accountant of recognized national standing selected by Borrower. The opinion of such independent certified public accountant shall not be acceptable to Bank if qualified due to any limitations in scope imposed by Borrower or any other person or entity. Any other qualification of the opinion by the accountant shall render the acceptability of the financial statements subject to Bank's approval. **Quarterly.** Borrower shall deliver to Bank, within 120 days after the close of each fiscal year and within 45 days after the end of each of the first three fiscal quarters in any fiscal year, quarterly financial statements including, without limitation, a balance sheet, profit and loss statement, statement of cash flows and officer's compliance certificate, with supporting schedules; all on a consolidated basis with respect to Borrower and its Subsidiaries, all in reasonable detail and (except for the absence of footnote disclosures and subject to year-end adjustments) prepared in conformity with generally accepted accounting principles, applied (except as otherwise disclosed in such financial statements) on a basis consistent with that of the preceding year. **Additional Information.** Borrower shall deliver to Bank such information as Bank may reasonably request from time to time pertaining to Borrower's corporate status, operations and financial condition. Borrower shall permit Bank and its representatives to meet with Borrower and discuss the business and finances of Borrower from time to time as Bank may reasonably request. **Accuracy.** All information provided Bank by Borrower shall be complete and accurate in all material respects.

AFFIRMATIVE COVENANTS. Borrower agrees that from the date hereof until payment in full of the Obligations: **Maintenance of Corporate Status.** Borrower shall maintain its corporate existence and qualification or registration in all jurisdictions where it is required to be qualified or registered under applicable law and shall not suffer loss of good standing status where it is incorporated or in jurisdictions where it is required to be qualified or registered under applicable law (except, in the case of foreign qualification, registration or good standing, where the failure to maintain such qualification or registration or the loss of such good standing status, as the case may be, could not be reasonably expected to have a Material Adverse Effect). **Compliance With Laws.** Borrower will, and will cause each of its Subsidiaries to, comply with all laws, rules, regulations and requirements of any governmental authority applicable to its properties, except where the failure to do so, either individually or in the aggregate, could not reasonably be expected to result in a Material Adverse Effect. **Insurance.** Borrower will, and will cause each of its Subsidiaries to, maintain, with financially sound and reputable insurance companies, adequate insurance coverage with respect to its properties and business against loss or damage of the kinds and in the amounts customarily insured against by companies of established reputation engaged in the same or similar businesses including, without limitation, commercial general liability insurance, workers compensation insurance, and business interruption insurance. **Maintain Properties.** Borrower will, and will cause each of its Subsidiaries to, maintain, preserve and keep its property in good repair, working order and condition, making all needed replacements, additions and improvements thereto. **Material Business Alteration.** Borrower will not, without prior written consent of Bank, materially alter the kind or type of Borrower's business.

FINANCIAL COVENANTS. Borrower agrees that from the date hereof until final payment in full of the Obligations, using the financial information for Borrower and its Subsidiaries, calculated on a consolidated basis: **Minimum Consolidated Interest Coverage Ratio.** Borrower will not, as of the last day of any fiscal quarter of Borrower, commencing with the fiscal quarter ending June 30, 2006, permit the Consolidated Interest Coverage Ratio for the period of four fiscal quarters ending on such day, to be less than 3.0 to 1.0. **Maximum Leverage Ratio.** Borrower will not, as of the last day of any fiscal quarter of Borrower, commencing with the fiscal quarter ending June 30, 2006, permit the Leverage Ratio for the period of four consecutive fiscal quarters ending on such day, to be greater than 3.0 to 1.0. **Definitions Applicable to Financial Covenants:** "Consolidated Interest Coverage Ratio" means, for any period of four consecutive fiscal quarters of Borrower, the ratio of (i) Consolidated EBITDA for such period to (ii) Consolidated Interest Expense for such period. "Leverage Ratio" means, as of the last day of any fiscal quarter of Borrower, the ratio of (i) Consolidated Total Debt to (ii) Consolidated EBITDA. The Leverage Ratio shall be calculated based upon (a) for Consolidated Total Debt, Consolidated Total Debt as of the last day of each such fiscal quarter, and (b) for Consolidated EBITDA, the actual amount for the period of four consecutive fiscal quarters of Borrower ending on such day. "Consolidated EBIT" means, for any period of four consecutive fiscal quarters of Borrower, on a consolidated basis for Borrower and its Subsidiaries in accordance with Agreement Accounting Principles, the sum of the amounts for such period, without duplication, of (i) net income, plus (ii) interest expense plus (iii) income taxes. "Consolidated Interest Expense" means, for any period of four consecutive fiscal quarters of the Borrower, total interest expense (whether paid or accrued) of the Borrower and its Subsidiaries for such period determined in accordance with Agreement Accounting Principles. "Consolidated Total Debt" means the aggregate principal amount of all Indebtedness on a consolidated basis of Borrower and its Subsidiaries as of a referenced date. "Indebtedness" means, without duplication, (i) obligations for borrowed money, (ii) obligations representing the deferred purchase price of property or services (other than accounts payable or accrued expenses arising in the ordinary course of such person's business payable on terms customary in the trade), (iii) obligations, whether or not assumed, secured by liens on or specifically payable out of the proceeds or production from property now or hereafter owned or acquired by such person, (iv) Letter of Credit obligations and (v) obligations which are evidenced by notes, acceptances, or other instruments. "Consolidated EBITDA" means for any period of four consecutive fiscal quarters of Borrower, on a consolidated basis for Borrower and its Subsidiaries in accordance with Agreement Accounting Principles, the sum of the amounts for such period, without duplication, of (i) Consolidated EBIT, plus (ii) depreciation plus (iii) amortization expense.

INDEMNIFICATION. The Borrower agrees to indemnify and hold harmless Bank, its officers, employees, directors, and authorized agents ("Indemnified Persons") from and against any and all liabilities, losses, damages, penalties, or costs and expenses of any kind, including, without limitation, the reasonable fees and disbursements of counsel, which may be incurred by any of them in connection with any claim or investigative, administrative or judicial proceeding relating to or arising out of the Loan Documents, the Obligations, the Letters of Credit or any actual or proposed use of proceeds of this Note; provided that no Indemnified Persons may recover hereunder any liabilities, losses, damages, penalties, or costs and expenses determined by a court of competent jurisdiction to have been caused by gross negligence or willful misconduct of such Indemnified Person or the breach by such Indemnified Person of its obligations under this Note or any of the other Loan Documents. The foregoing indemnity obligation shall be an Obligation hereunder. The indemnity provided for herein shall survive payment of the Obligations.

WAIVERS AND AMENDMENTS. No waivers, amendments or modifications of this Note and other Loan Documents shall be valid unless in writing and signed by an officer of the party against which enforcement of the same is sought. No waiver by Bank of any Default shall operate as a waiver

of any other Default or the same Default on a future occasion. Neither the failure nor any delay on the part of Bank in exercising any right, power, or remedy under this Note and other Loan Documents shall operate as a waiver thereof, nor shall a single or partial exercise thereof preclude any other or further exercise thereof or the exercise of any other right, power or remedy.

Each of Borrower and any other person liable under this Note (an “Obligor”) waives presentment, protest, notice of dishonor, demand for payment, notice of intention to accelerate maturity, notice of acceleration of maturity, notice of sale and all other notices of any kind (except for notices expressly required by this Note or any of the other Loan Documents). Further, each Obligor other than Borrower agrees that Bank may extend, modify or renew this Note or make a novation of the loan evidenced by this Note for any period, and each Obligor agrees that Bank may grant any releases, compromises or indulgences with respect to any collateral securing this Note, or with respect to any other Obligor, all without notice to or consent of such Obligor and without affecting the liability of such Obligor.

MISCELLANEOUS PROVISIONS. Assignment. This Note and the other Loan Documents shall inure to the benefit of and be binding upon the parties and their respective successors and assigns. Bank’s interests in and rights under this Note and the other Loan Documents are assignable, in whole or in part, by Bank only with the prior written consent of Borrower (which may not be unreasonably withheld), except that no such consent of Borrower shall be required at any time a Default has occurred and is continuing. Borrower shall not assign its rights and interest hereunder without the prior written consent of Bank, and any attempt by Borrower to assign without Bank’s prior written consent is null and void. Any assignment shall not release Borrower from the Obligations. **Applicable Law.** This Note and, unless otherwise provided in any other Loan Document, the other Loan Documents shall be governed by and construed under the laws of the state named in Bank’s address on the first page hereof without regard to that state’s conflict of laws principles. **Severability.** If any provision of this Note or of the other Loan Documents shall be prohibited or invalid under applicable law, such provision shall be ineffective but only to the extent of such prohibition or invalidity, without invalidating the remainder of such provision or the remaining provisions of this Note or other such document. **Notices.** Any notices to Borrower shall be sufficiently given, if in writing and mailed or delivered to the Borrower’s address shown above or such other address as provided hereunder, and to Bank, if in writing and mailed or delivered to the address shown above or such other address as Bank may specify in writing from time to time. Any notice permitted to be given to Bank telephonically shall be given by calling Michael J. Reymann (or such other individual as Bank may specify in writing from time to time) at (612) 303-3781 (or such other telephone number as Bank may specify in writing from time to time). In the event that Borrower changes Borrower’s address at any time prior to the date the Obligations are paid in full, Borrower agrees to promptly give written notice of said change of address by registered or certified mail, return receipt requested, all charges prepaid. **Plural; Captions.** All references in the Loan Documents to nouns of reference mean both the singular and plural form, as the case may be, and the term “person” shall mean any individual, person or entity. The captions contained in the Loan Documents are inserted for convenience only and shall not affect the meaning or interpretation of the Loan Documents. **Advances.** Bank may, in its sole discretion, make other advances, which shall be deemed to be advances under this Note, even though the stated principal amount of this Note may be exceeded as a result thereof. **Posting of Payments.** All payments received during normal banking hours after 2:00 p.m. local time at the office of Bank first shown above shall be deemed received at the opening of the next New York Banking Day. **Fees and Taxes.** Borrower shall promptly pay all documentary, intangible recordation and/or similar taxes on this transaction whether assessed at closing or arising from time to time.

CONFIDENTIALITY. Bank agrees to keep confidential all non-public information provided to it by or on behalf of Borrower or any Subsidiary of Borrower pursuant to this Note or any of the other Loan Documents, and to limit its use of such information to the evaluation, administration and/or enforcement of this Note or any of the other Loan Documents; provided, however, that nothing herein shall prevent Bank from disclosing such information (i) to any actual or prospective assignee in connection with the contemplated assignment of Bank’s interests in and rights under this Note so long as such actual or potential assignee has, prior to receiving any such information, agreed in writing to preserve the confidential nature thereof on terms no less restrictive than those contained in this Section, (ii) to its employees, directors, agents, attorneys, accountants and other professional advisors as need to know such information, (iii) in response to any order of any court or other governmental authority or as may otherwise be required by law, or (iv) in connection with the exercise by Bank of any remedy under this Note or any of the other Loan Documents.

Consent to Jurisdiction. AT THE OPTION OF THE BANK, THIS NOTE MAY BE ENFORCED IN ANY FEDERAL COURT OR MINNESOTA STATE COURT SITTING IN MINNEAPOLIS OR ST. PAUL, MINNESOTA; AND THE BORROWER CONSENTS TO THE JURISDICTION AND VENUE OF ANY SUCH COURT AND WAIVES ANY ARGUMENT THAT VENUE IN SUCH FORUMS IS NOT CONVENIENT. IN THE EVENT THE BORROWER COMMENCES ANY ACTION IN ANOTHER JURISDICTION OR VENUE UNDER ANY TORT OR CONTRACT THEORY ARISING DIRECTLY OR INDIRECTLY FROM THE RELATIONSHIP CREATED BY THIS NOTE, THE BANK AT ITS OPTION SHALL BE ENTITLED TO HAVE THE CASE TRANSFERRED TO ONE OF THE JURISDICTIONS AND VENUES ABOVE-DESCRIBED, OR IF SUCH TRANSFER CANNOT BE ACCOMPLISHED UNDER APPLICABLE LAW, TO HAVE SUCH CASE DISMISSED WITHOUT PREJUDICE.

Waiver of Jury Trial. THE PARTIES ACKNOWLEDGE THAT BY AGREEING TO BINDING ARBITRATION THEY HAVE IRREVOCABLY WAIVED ANY RIGHT THEY MAY HAVE TO JURY TRIAL WITH REGARD TO A DISPUTE.

IN WITNESS WHEREOF, Borrower, on the day and year first above written, has caused this Note to be executed under seal.

Graco Inc.
Taxpayer Identification Number: 41-0285640

By: /s/James A. Graner (SEAL)
Name: James A. Graner, Title: Chief Financial Officer

Agreed and Accepted as of the
day and year first above written:

U.S. Bank National Association

By: /s/Peter I. Bystol
Name: Peter I. Bystol, Title: AVP

**GRACO
RESTORATION PLAN
(2005 Restatement)**

**GRACO
RESTORATION PLAN
(2005 Statement)**

TABLE OF CONTENTS

	Page
SECTION 1. INTRODUCTION AND DEFINITIONS	1
1.1. Preamble	
1.2. Definitions	
1.2.1. Chief Administrative Officer	
1.2.2. Committee	
1.2.3. Compensation	
1.2.4. Disability	
1.2.5. Effective Date	
1.2.6. Employer	
1.2.7. Graco	
1.2.8. Graco Employee Retirement Plan	
1.2.9. Participant	
1.2.10. Plan	
1.2.11. Plan Statement	
1.2.12. Separation from Service	
SECTION 2. ELIGIBILITY TO PARTICIPATE	4
2.1. General Eligibility Rule	
2.2. Selection for Participation in the Plan	
SECTION 3. CONTRIBUTIONS	5
3.1. Participant Contributions	
3.2. Graco Contributions	
SECTION 4. BENEFITS	6
4.1. Benefits in General	
4.2. Retirement Benefits	
4.3. Death Benefit	
4.4. Effect of Misstatements by Participants	
SECTION 5. VESTING	8
SECTION 6. UNFUNDED PLAN	9
SECTION 7. DISTRIBUTIONS	10
7.1. Distribution	
7.1.1. Time of Distribution	
7.1.2. Form of Distribution	
7.1.3. Taxation of Distribution	
7.2. General Distribution Rules	
7.2.1. Distribution in Cash	
7.2.2. Facility of Payment	
7.2.3. Non-Duplication of Benefits	
SECTION 8. SPENDTHRIFT PROVISION	12
SECTION 9. AMENDMENT AND TERMINATION	13
9.1. Amendment	
9.2. Discontinuance of Contributions and Termination of the Plan	
9.3. Merger or Spinoff of Plans	
9.3.1. In General	
9.3.2. Beneficiary Designations	
SECTION 10. INDEMNIFICATION	14

SECTION 11. DETERMINATIONS — CLAIM PROCEDURES 15

- 11.1. Determinations
- 11.2. Claim and Review Procedures

SECTION 12. PLAN ADMINISTRATION 16

- 12.1. Board of Directors
- 12.2. Committee
- 12.3. Chief Administrative Officer
- 12.4. Fiduciary Responsibility — In General
 - 12.4.1. Limitation on Authority
 - 12.4.2. Dual Capacity
- 12.5. Administrator
- 12.6. Named Fiduciaries
- 12.7. Service of Process
- 12.8. Rules and Regulations
- 12.9. Method of Executing Instruments
- 12.10. Information Furnished by Participants
- 12.11. Receipt of Documents
- 12.12. Powers of Attorney
- 12.13. Guardians and Conservators

SECTION 13. IN GENERAL 19

- 13.1. Disclaimers
 - 13.1.1. Effect on Employment
 - 13.1.2. Sole Source of Benefits
- 13.2. Applicable Laws
 - 13.2.1. ERISA Status
 - 13.2.2. Internal Revenue Code Status
- 13.3. Choice of Law

SCHEDULE I— EMPLOYERS PARTICIPATING SI-1

**GRACO
RESTORATION PLAN
(2005 Statement)**

SECTION 1

INTRODUCTION AND DEFINITIONS

1.1. Preamble. Effective as of July 1, 1998, the Board of Directors of Graco Inc. ("Graco"), a Minnesota corporation, established an unfunded restoration benefit plan (the "Plan") consisting of:

- (a) an excess benefit plan designed to provide retirement benefits to eligible employees as a replacement for the retirement benefits limited under the Graco Employee Retirement Plan by operation of Section 415 of the Code ("Plan A"), which plan is not subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), and
- (b) an excess compensation plan designed to provide benefits to eligible employees as a replacement for the retirement benefits limited under the Graco Employee Retirement Plan by operation of Section 401(a)(17) of the Code ("Plan B"), which plan is subject to ERISA as a so-called "top hat" plan for a select group of management or highly compensated employees.

Effective January 1, 2005, Graco restated the Plan in this nonqualified, unfunded, deferred compensation plan under section 409A of the Internal Revenue Code for the benefit of a select group of management or highly compensated employees of Graco and participating Employers.

1.2. Definitions. The definitions contained in Subsection 1.1 and the Rules of Interpretation contained in Subsection 1.2 of the Graco Employee Retirement Plan, as the same may be amended from time to time, are hereby incorporated herein by reference as if set forth herein in full, subject to the following qualifications. When the following terms are used herein with initial capital letters, they shall have the following meanings:

1.2.1. Chief Administrative Officer — the Chief Administrative Officer, the Vice President of Human Resources, or the senior officer responsible for the human resources function.

1.2.2. Committee — the Compensation Committee of the Board of Directors.

1.2.3. Compensation — "Compensation" as defined in the Graco Employee Retirement Plan, but disregarding Section 1.1.12(g) of the definition in the Graco Employee Retirement Plan it shall include Participant contributions to the Graco Deferred Compensation Plan (2005 Statement).

1.2.4. Disabled or Disability — an impairment which renders a Participant unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than twelve (12) months. A Disability must be evidenced by (i) a certification by a doctor of medicine, or (ii) the official written determination that the individual will be eligible for disability benefits under the federal Social Security Act.

1.2.5. **Effective Date** — January 1, 2005.

1.2.6. **Employer** — each of the following employers:

- (a) Graco,
- (b) Any employer affiliated with Graco that adopts the Plan with the consent of Graco and subject to such limitations (not inconsistent with federal law) as Graco may impose with respect to the extent that service with such employer prior to such adoption will be included in determining an employee's initial eligibility to enroll as a Participant in the Plan, and
- (c) Any successor thereof that adopts the Plan.

The name of each Employer, the effective date of its adoption of the Plan, and a specification of whether an employee's pre-adoption service with such Employer will be included in determining the Participant's initial eligibility to enroll as a Participant in the Plan shall be set forth in Schedule I to this Plan Statement.

1.2.7. **Graco** — Graco Inc., a Minnesota corporation, and any successor thereof.

1.2.8. **Graco Employee Retirement Plan** — the tax-qualified defined benefit pension plan established by Graco for the benefit of employees eligible to participate therein, as amended in the written document entitled "Graco Employee Retirement Plan (1991 Restatement)" as the same may be further amended from time to time.

1.2.9. **Participant** — an employee of an Employer who is selected for participation in the Plan. An employee who has become a Participant shall continue as a Participant in the Plan until the date of the Participant's death or, if earlier, the date upon which the Participant has received a distribution of the Participant's entire Account under the Plan.

1.2.10. **Plan** — the nonqualified, unfunded, deferred compensation plan of Graco established for the benefit of employees eligible to participate therein, as first set forth in this Plan Statement. (As used herein, "Plan" refers to the legal entity established by Graco and not to the documents pursuant to which the Plan is maintained. Those documents are referred to herein as the "Plan Statement.") The Plan shall be referred to as the "Graco Restoration Plan."

1.2.11. **Plan Statement** — this document entitled "Graco Restoration Plan (2005 Restatement)," as the same may be amended from time to time.

1.2.12. **Separation from Service** — "Termination of Employment" as defined in the Graco Employee Retirement Plan, except a Termination of Employment shall occur only when a Participant has a separation from service for the purposes of section 409A of the Code.

SECTION 2

ELIGIBILITY TO PARTICIPATE

2.1. **General Eligibility Rule.** An employee of an Employer who satisfies the following three conditions:

- (a) is a Participant in the Graco Employee Retirement Plan, and
- (b) has experienced a legislated reduction in benefits under the Graco Employee Retirement Plan due to limitations imposed by section 415 of the Code, section 401(a)(17) of the Code, or who have experienced a reduction in benefits due to Participant contributions to the Graco Deferred Compensation Plan (2005 Statement), and
- (c) is selected for participation (as described in Section 2.2),

shall be eligible to become a Participant.

2.2. **Selection for Participation in the Plan.** Only employees who are selected for participation in the Plan by the Chief Administrative Officer shall be eligible to become a participant in the Plan. The Chief Administrative Officer shall not select any employee for participation unless the Chief Administrative Officer determines that such employee is a member of a select group of management or highly compensated employees (as that expression is used in ERISA). Notwithstanding the foregoing, any employee who was a Participant in the Plan on December 31, 2004 shall continue to be a Participant in the Plan.

SECTION 3

CONTRIBUTIONS

3.1. **Participant Contributions.** No employee contributions are permitted under the Plan.

3.2. **Graco Contributions.** Graco may, in its sole discretion, establish a rabbi trust and make employer discretionary contributions to a rabbi trust to fund benefits due under the Plan.

SECTION 4

BENEFITS

4.1. **Benefits in General.** The benefits under the Plan are based on the formula contained in the Graco Employee Retirement Plan. Although the benefit amount is based on the formula in the Graco Employee Retirement Plan, no elections or optional forms of settlement under the Graco Employee Retirement Plan shall apply to the benefits under the Plan.

4.2. **Retirement Benefits.** For Participants who have a Separation from Service on or after October 1, 2006, upon the first day of the month after the later of (i) the Participant attains age 62, or (ii) the Participant has a Separation from Service, this Plan shall pay as a benefit to a Participant the excess, if any, of:

- (a) the amount that would have been payable to the Participant under the Graco Employee Retirement Plan if such benefit had been determined:
 - (i) without regard to the benefit limitations under section 415 of the Code,
 - (ii) without regard to the compensation limitation of section 401(a)(17) of the Code,
 - (iii) by substituting the modified definition of "Compensation" contained in this Plan for the definition of "Compensation" contained in the Graco Employee Retirement Plan, and
 - (iv) disregarding, however, any Accrued Benefit over an amount equal to the limit under section 401(a)(17) of the Code in the year payment of the benefit commences; minus
- (b) the amount paid and any amount to be paid from the Graco Employee Retirement Plan.

For Participants who have a Separation from Service before October 1, 2006, upon the first day of the month after the later of (i) the Participant attains age 62, or (ii) the Participant has a Separation from Service, this Plan shall pay as a benefit to a Participant the excess, if any, of:

- (a) the amount that would have been payable to the Participant under the Graco Employee Retirement Plan if such benefit had been determined:
 - (i) without regard to the benefit limitations under section 415 of the Code,
 - (ii) without regard to the compensation limitation of section 401(a)(17) of the Code,
 - (iii) by substituting the modified definition of "Compensation" contained in this Plan for the definition of "Compensation" contained in the Graco Employee Retirement Plan, and
 - (iv) disregarding, however, any Accrued Benefit over \$170,000 per year; minus
- (b) the amount paid and any amount to be paid from the Graco Employee Retirement Plan.

4.3. **Death Benefits.** If a Participant dies before distribution of the Participant's benefit is to commence and the Participant is married, the Plan shall pay as a benefit to the surviving spouse of a Participant, the excess, if any, of the amount determined under Subsection 4.2 that would be paid to a surviving spouse under the Graco Employee Retirement Plan.

4.4. **Effect of Misstatements by Participants.** If any Participant in any written statement required by an Employer or the Committee under the Plan misstates his age or the age of any person upon whose survival the payment of any benefit in respect of such Participant is contingent or any other fact the misstatement of which would affect the amount of the benefit payable hereunder, the amount of the benefit to be available with respect to such Participant will be adjusted retroactively to the amount which would have been payable if such fact or facts had not been misstated; provided, however, that in no event will the Plan be liable to pay any greater benefit with respect to any Participant than that which would have been payable on the basis of the truth.

SECTION 5

VESTING

A Participant shall be fully vested in the funds credited to the Participant's Account at all times.

SECTION 6

UNFUNDED PLAN

The obligations to make payments under the Plan constitute only the unsecured (but legally enforceable) promises of Graco to make such payments. No Participant shall have any lien, prior claim or other security interest in any property of Graco and Affiliates. Graco shall have no obligation to establish or maintain any fund, trust or account (other than a bookkeeping account) for the purpose of funding or paying the benefits promised under the Plan. If such a fund, trust or account is established, the property therein that is allocable to an Employer shall remain the sole and exclusive property of that Employer.

SECTION 7

DISTRIBUTIONS

7.1. Distribution.

7.1.1. Time of Distribution.

- (a) **Default Time of Distribution.** A Participant's benefit shall commence as of the first day of the month after the later of the date (i) the Participant attains age 62, or (ii) the Participant has a Separation from Service. If a Participant dies before distribution of the Participant's benefit is to commence and the Participant is married, the Participant's benefit shall commence as of the first day of the month after the date the Participant would have attained age 62 (if the Participant had not died). If a Participant dies before distribution of the Participant's benefit is to commence and the Participant is single, no benefit will be paid under the Plan.
- (b) **Delay in Distribution to Key Employees.** Notwithstanding the foregoing, in the case of a distribution to a Participant who is a key employee where the timing of the distribution is based on the key employee's Separation from Service, the date of distribution to the key employee shall be the first day of the month following the date that is six (6) months after the date of the key employee's Separation from Service (or, if earlier, the date of the Participant's death). A key employee shall be a key employee as defined in section 416(i) of the Code without regard to paragraph 5 of section 416(i) of the Code. All distributions under this Plan shall comply with the requirements of section 409A(a)(2)(B)(i) of the Code.

7.1.2. Form of Distribution.

- (a) **Default Form of Distribution.** If a Participant is married at the time distribution of a Participant's benefit is to commence, a Participant's benefit shall be paid in the form of a Qualified Joint and Survivor Annuity Form (an joint and survivor annuity paid over the life of the Participant and the annuity reduced and 50% of the annuity paid to the spouse after the Participant's death if the spouse survives the Participant, although the annuity shall not be subject to the rules governing qualified joint and survivor annuities under the Code). If a Participant is single at the time distribution of a Participant's benefit is to commence, a Participant's benefit shall be paid in the Basic Pension Form (a single life annuity). If a Participant dies before distribution of the Participant's benefit is to commence and the Participant is married, a Participant's benefit shall be paid to the Participant's spouse in the form of a survivor annuity as described under Section 4.1 of the Graco Employee Retirement Plan. If a Participant dies before distribution of the Participant's benefit is to commence and the Participant is single, no benefit will be paid under the Plan.
- (b) **Small Amount Lump Sum Distribution.** If the value of a Participant's benefit under the Plan as of the date the Participant's benefit is to commence is Ten Thousand Dollars (\$10,000) or less, the benefit shall be paid in a single lump sum payment.

7.1.3. **Taxation of Distribution.** The Participant's benefit shall be subject to Federal income and employment taxes at the time of payment or such earlier date as provided under the Code. The Participant's benefit shall also be subject to applicable state taxes.

7.2. General Distribution Rules.

7.2.1. **Distribution in Cash.** Distribution of a Participant's benefit shall be made in cash.

7.2.2. **Facility of Payment.** In case of the legal disability, including minority, of a Participant or Beneficiary entitled to receive any distribution under the Plan, payment shall be made, if the Chief Administrative Officer shall be advised of the existence of such condition:

- (a) To the duly appointed guardian or conservator of such Participant or Beneficiary, or
- (b) To the duly appointed attorney-in-fact or other legal representative of such Participant or Beneficiary, or
- (c) To a person or institution entrusted with the care or maintenance of the incompetent or disabled Participant or Beneficiary, provided, however, such person or institution has satisfied the Chief Administrative Officer that the payment will be used for the best interest and assist in the care of such Participant or Beneficiary, and provided further, that no prior claim for said payment has been made by a duly appointed guardian, conservator, attorney-in-fact or other legal representative of such Participant or Beneficiary as provided above.

Any payment made in accordance with the foregoing provisions of this section shall constitute a complete discharge of any liability or obligation of Graco and the Employers therefore.

7.2.3. **Non-Duplication of Benefits.** There shall be no duplication of benefits under the Plan by itself, or under and the Plan and the Graco Employee Retirement Plan. If by reason of employment a Participant is eligible for more than one benefit, the Participant shall receive only one benefit.

SECTION 8

SPENDTHRIFT PROVISION

No Participant or Beneficiary shall have any transmissible interest in any Account nor shall any Participant or Beneficiary have any power to anticipate, alienate, dispose of, pledge or encumber the same, nor shall the Plan recognize any assignment thereof, either in whole or in part, nor shall the Account be subject to attachment, garnishment, execution following judgment or other legal process (including without limitation any domestic relations order, whether or not a "qualified domestic relations order" under section 414(p) of the Code and section 206(d) of ERISA) before the Account is distributed to the Participant or Beneficiary.

The power to designate Beneficiaries to receive the Account of a Participant in the event of death shall not permit or be construed to permit such power or right to be exercised by the Participant so as thereby to anticipate, pledge, mortgage or encumber the Participant's Account or any part thereof, and any attempt of a Participant so to exercise said power in violation of this provision shall be of no force and effect and shall be disregarded by Graco, the Committee, and the Chief Administrative Officer.

SECTION 9

AMENDMENT AND TERMINATION

9.1. **Amendment.** Graco reserves the power to amend this Plan Statement either prospectively or retroactively or both:

- (a) in any respect by action of its Board of Directors;
- (b) in any respect that does not materially increase the cost of the Plan by action of the Committee; and
- (c) in any respect with regard to eligibility, to add or remove participating employers by action of the Chief Administrative Officer.

The power to amend this Plan Statement may not be delegated.

9.2. **Discontinuance of Contributions and Termination of Plan.** Graco also reserves the right, by action of its Board of Directors, at any time to totally or partially terminate the Plan, and to reduce, suspend or discontinue contributions to the Plan.

9.3. **Merger or Spinoff of Plans.**

9.3.1. **In General.** The Committee may cause all or a part of the Plan to be merged with all or a part of any other plan. The Committee may cause all or a part of the Plan to be spun off to another plan.

9.3.2. **Beneficiary Designations.** If assets and liabilities are transferred from another plan to the Plan, Beneficiary designations made under that plan shall become void with respect to deaths occurring on or after the date as of which such transfer is made and the Beneficiary designation rules of this Plan Statement shall apply beginning on such date.

SECTION 10

INDEMNIFICATION

Except as prohibited by applicable law, Graco shall defend, indemnify and hold harmless from any and all liabilities, costs and expenses (including legal fees), to the extent not covered by insurance, each officer, director or employee of Graco, who is a party to or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding with respect to the Plan, whether imposed under ERISA or otherwise, wherever brought, whether civil, criminal, administrative or investigative by reason of the fact that the individual is or was a fiduciary or administrator of the Plan (as defined in ERISA), or by reason of acting in any other capacity in connection with the Plan. No such indemnification, however, shall be required or provided if such liability arises (i) from the individual's claim for the individual's own benefit, (ii) from the proven willful misconduct, fraud or the bad faith of the individual, or (iii) from the criminal misconduct of such individual if the individual had reason to believe the conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith, and, with respect to any criminal action or proceeding, had reasonable cause to believe that the individual's conduct was unlawful. This indemnification shall continue as to an individual who has ceased to be an officer, director or employee of Graco and shall inure to the benefit of the heirs, executors and administrators of such an individual.

SECTION 11

DETERMINATIONS — CLAIM PROCEDURES

11.1. **Determinations.** The benefits under the Plan will be paid only if the Chief Administrative Officer and, to the extent a Participant appeals a claim, the Committee decide in their discretion that the applicant is entitled to them. The Chief Administrative Officer has discretionary authority to grant or deny benefits under the Plan. The Chief Administrative Officer shall have the sole discretion, authority and responsibility to interpret and construe this Plan Statement and all relevant documents and information, and to determine all factual and legal questions under the Plan, including but not limited to the entitlement of all persons to benefits and the amounts of their benefits. The Chief Administrative Officer shall make such determinations as may be required from time to time in the administration of the Plan. This discretionary authority shall include all matters arising under the Plan. An application for a distribution shall be considered as a claim.

11.2. **Claim and Review Procedures.** Until modified by the Committee, the claim and review procedures set forth in the Graco Employee Retirement Plan shall be the mandatory claims and review procedure for the resolution of disputes and disposition of claims filed under the Plan to be reviewed by the Chief Administrative Officer and the Committee.

SECTION 12

PLAN ADMINISTRATION

12.1. **Board of Directors.** The Board of Directors shall have the authority to amend, freeze or terminate the Plan.

12.2. **Committee.** Functions generally assigned to the Committee may be delegated to and discharged by Graco's officers or a committee.

12.3. **Chief Administrative Officer.** Functions generally assigned to the Chief Administrative Officer may be delegated to and discharged by employees of Graco's Human Resources Department. The Vice President shall not have any authority with respect to the determination of any matter specially affecting his or her individual interest in the Plan (as distinguished from the interests of all Participants and Beneficiaries or a broad class of Participants and Beneficiaries), all such authority being vested in and exercisable only by the Committee.

12.4. **Fiduciary Responsibility — In General.**

12.4.1. **Limitation on Authority.** No action taken by any fiduciary, if authority to take such action has been delegated or redelegated to it, shall be the responsibility of any other fiduciary except as may be required by the provisions of ERISA. Except to the extent imposed by ERISA, no fiduciary shall have the duty to question whether any other fiduciary is fulfilling all of the responsibility imposed upon such other fiduciary by this Plan Statement or by ERISA

12.4.2. **Dual Capacity.** Any person or group of persons may serve in more than one fiduciary capacity with respect to the Plan.

12.5. **Administrator.** Graco shall be the administrator for purposes of section 3(16)(A) of ERISA.

12.6. **Named Fiduciaries.** The Chief Administrative Officer and the Committee shall be named fiduciaries.

12.7. **Service of Process.** In the absence of any designation to the contrary by Graco, the General Counsel of Graco is designated as the appropriate and exclusive agent for the receipt of service of process directed to the Plan in any legal proceeding, including arbitration, involving the Plan.

12.8. **Rules and Regulations.** Any rule not in conflict or at variance with the provisions hereof may be adopted by the Committee.

12.9. **Method of Executing Instruments.** Information to be supplied or written notices to be made or consents to be given by Graco or the Committee pursuant to any provision of this Plan Statement may be signed in the name of Graco by any officer or by any employee who has been authorized to make such certification or to give such notices or consents or by any Committee member.

12.10. **Information Furnished by Participants.** Neither Graco, the Committee, or the Chief Administrative Officer shall be liable or responsible for any error in the computation of the Account of a Participant resulting from any misstatement of fact made by the Participant, directly or indirectly, to Graco, the Committee, or the Chief Administrative Officer, and used by them in determining the Participant's Account. Neither Graco, the Committee, or the Chief Administrative Officer shall be obligated or required to increase the Account of such Participant which, on discovery of the misstatement, is found to be understated as a result of such misstatement of the Participant. However, the Account of any Participant which is overstated by reason of any such misstatement shall be reduced to the amount appropriate for the Participant in view of the truth.

12.11. **Receipt of Documents.** If a form or document must be filed with or received by Graco, the Committee, or the Chief Administrative Officer (the "appropriate entity"), it must be actually received by the appropriate entity to be effective. The determination of whether or when a form or document has been received by the appropriate entity shall be made by the Chief Administrative Officer on the basis of what documents are acknowledged by the appropriate entity to be in its actual possession without regard to the "mailbox rule" or similar rule of evidence. The absence of a document in the appropriate entity's records and files shall be conclusive and binding proof that the document was not received by the appropriate entity.

12.12. **Powers of Attorney.** The Plan shall recognize a document submitted to the Chief Administrative Officer by which a Participant or Beneficiary appoints another person as his or her attorney in fact, under the following rules:

- (a) that neither Graco or the Chief Administrative Officer shall be required to determine whether the document complies with the applicable state law regarding powers of attorneys or attorneys in fact;
- (b) that if the document enumerates one or more specific powers in addition to a general power to act, the enumeration of one or more specific powers shall not be deemed to limit the generality of the general power to act; in other words, the general power shall continue to be in force; and
- (c) that the document is signed by the Participant or Beneficiary and is notarized.

The Chief Administrative Officer may establish additional rules for the acceptance of powers of attorneys for Plan purposes. The Chief Administrative Officer may review the document as to whether it complies with the rules. If there is a conflict between the action of a court appointed guardian or conservator and an attorney in fact, then the authority of the court appointed guardian or conservator shall be recognized as superior to that of an attorney in fact.

12.13. **Guardians and Conservators.** The Plan shall recognize the authority of a court appointed guardian or conservator to act on behalf of a Participant or Beneficiary to the extent such action is within the authority granted to the court appointed guardian or conservator.

SECTION 13

IN GENERAL

13.1. Disclaimers.

13.1.1. **Effect on Employment.** Neither the terms of this Plan Statement nor the benefits hereunder nor the continuance thereof shall be a term of the employment of any employee, and Graco shall not be obligated to continue the Plan. The terms of this Plan Statement shall not give any employee the right to be retained in the employment of an Employer.

13.1.2. **Sole Source of Benefits.** Neither Graco nor any of its officers nor any member of its Board of Directors nor any member of the Committee in any way guarantee Participant Accounts against loss or depreciation, nor do they guarantee the payment of any benefit or amount which may become due and payable hereunder to any Participant, Beneficiary, or other person. Each Participant, Beneficiary, or other person entitled at any time to payments hereunder shall look solely to the assets of Graco and the Participant's Employer for such payments. If an Account shall have been distributed to a former Participant, Beneficiary, or any other person entitled to the receipt thereof, such former Participant, Beneficiary, or other person, as the case may be, shall have no further right or interest in the other assets.

13.2. Applicable Laws.

13.2.1. **ERISA Status.** The Plan is maintained with the understanding that the Plan is an unfunded plan maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees as provided in sections 201(2), 301(3) and 401(a)(1) of ERISA, and section 2520.104-23 of the regulations under ERISA. Each provision shall be interpreted and administered accordingly.

13.2.2. **Internal Revenue Code Status.** The Plan is maintained as a nonqualified deferred compensation arrangement under section 409A of the Code. The rules of section 401(a) *et. seq.* of the Code shall not apply to the Plan. The rules of sections 3121(v) and 3306(r)(2) of the Code shall apply to the Plan. Each provision shall be interpreted and administered accordingly. Notwithstanding the foregoing, neither Graco nor any of its officers, directors, agents or affiliates shall be obligated, directly or indirectly, to any Participant or any other person for any taxes, penalties, interest or like amounts that may be imposed on the Participant or other person on account of any amounts under this Plan or on account of any failure to comply with the Code.

13.3. **Choice of Law.** This instrument has been executed and delivered in the State of Minnesota and, except to the extent that federal law is controlling, shall be construed and enforced in accordance with the laws of the State of Minnesota.

SCHEDULE I

EMPLOYERS PARTICIPATING

	<u>Name of Employer</u>	<u>Effective Date of Plan Adoption</u>
1.	Graco Inc.	01/01/1998
2.	Graco Minnesota Inc.	01/01/1998

CERTIFICATION

I, David A. Roberts, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Graco Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 25, 2006

/s/David A. Roberts

David A. Roberts
Chairman, President and Chief Executive Officer

CERTIFICATION

I, James A. Graner, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Graco Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 25, 2006

/s/James A. Graner

James A. Graner
Chief Financial Officer and Treasurer

CERTIFICATION UNDER SECTION 1350

Pursuant to Section 1350 of Title 18 of the United States Code, each of the undersigned certifies that this periodic report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in this periodic report fairly presents, in all material respects, the financial condition and results of operations of Graco Inc.

Date: October 25, 2006

/s/David A. Roberts

David A. Roberts
Chairman, President and Chief Executive Officer

Date: October 25, 2006

/s/James A. Graner

James A. Graner
Chief Financial Officer and Treasurer